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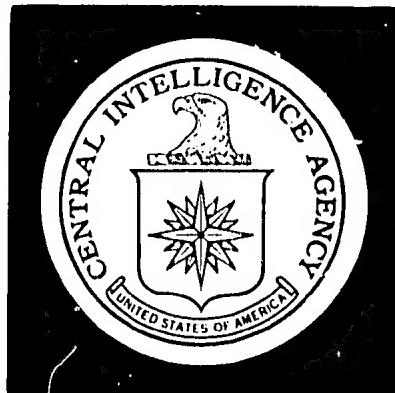


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Some Implications For The United States Of The Likely
Massive Increase In Middle East Foreign Exchange Reserves*

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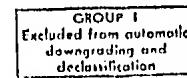
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ER IM 71-114
June 1971

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1971

INTELLIGENCE MEMORANDUM

Some Implications For The United States
Of The Likely Massive Increase
In Middle East Foreign Exchange Reserves

Introduction

1. In the past year, the Persian Gulf and Mediterranean oil exporting states have secured substantial increases in their oil taxes. Revenues will be boosted further in most of the countries by rising oil production. The increase in incomes raises the possibility of substantial growth in imports and foreign aid. However, the collective gold and foreign exchange reserves of Libya, Saudi Arabia, Iran, Kuwait, Iraq, Algeria, Abu Dhabi, and Qatar probably will grow from \$5.6 billion at the end of 1970 to more than \$25 billion at the close of 1975. This memorandum examines some of the implications of these developments for the United States.

Conclusions

2. Persian Gulf and North African oil producing states will receive huge increases in hard currency earnings over the next five years. In most of these countries, the likely level of expenditures on domestic investment and improved living standards fall far short of projected revenues. Nor are increases in external aid by the Arab states likely to affect the payments surplus materially. As a consequence, the accumulation of foreign exchange reserves in the geographic area could easily exceed \$25 billion by 1975, an amount well over twice the size of current US

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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reserves. This accumulation of funds will represent both a commercial opportunity and a political challenge to the United States.

3. There appears to be potential for a sizable percentage increase in US exports, particularly of capital goods associated with the oil and petro-chemical industries or with general economic development programs. US exports to these countries now greatly exceed US purchases from them, but these sales amount to only about 2% of all US exports, and the short-term potential for raising sales in absolute terms would seem to be limited by both political and economic considerations.

4. The United States' two best customers in the group, Iran and Saudi Arabia, are expected to experience the largest gains in oil revenues. Iran, which now takes over 40% of US exports to the countries under review, has economic development and military procurement programs under way which fully offset its foreign exchange revenues. Iran has shopped extensively for needed imports and has taken advantage of both Communist and West European concessions on prices and credit terms for competing economic and military goods. The potential for raising US exports of capital goods and military equipment to Saudi Arabia is favorable. However, Saudi financial policies are conservative, and a sizable portion of the increased revenues probably will be put into foreign exchange reserves.

5. Weakening Franco-Algerian ties and the improvement in US-Algerian relations provide the United States with improved commercial potential. Kuwait, Abu Dhabi, and Qatar probably will increase their imports from the United States as oil revenues grow, but these small countries have a combined population of less than one million persons and limited development programs. Consequently, most of the increase in revenues will not be spent but will be added to reserves. Waning British influence in the Gulf may help to divert some purchases from Britain to the United States. At present, US exports to Libya are hampered by political restraints. Cool political relations also have been a restraining factor in Iraq, but as in the Libyan case, the growth potential for imports is large.

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6. The principal item in the US balance of payments with the Middle Eastern and North African oil countries is not trade but repatriation of oil companies' earnings. The roughly \$3 billion of US private oil company investment yields an annual inflow of \$1.6 billion from eight countries. A US surplus in commodity trade brings the annual balance-of-payments surplus to over \$2 billion.

7. Accumulation of huge foreign exchange reserves would permit the Middle East oil producing states to carry out a number of actions which would be unfavorable to US interests. These include:

a. Nationalization of foreign-owned companies. Partial nationalization has already taken place in Algeria, and nationalization has been threatened in other countries, particularly Libya. By 1975, extensive nationalization could be carried out, and even if full compensation were paid, there would be considerable damage to the US balance of payments from loss of profit repatriation.

b. Subsidization of Arab governments and political movements. Arab oil money is already being used for such subsidies, including aid to Egypt and Jordan (under the 1967 Khartoum Agreement) [redacted]

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[redacted] Should radical power expand in the area, US policy objectives could be seriously affected.

c. Financial manipulation. The huge reserves expected to be under Middle Eastern control could be used to bring pressure in the West -- for example, by demanding payment for dollar reserves in gold. However, it is not clear that such actions could actually be carried out without cost to the initiating countries, and governments of the wealthy oil states have shown little taste for this type of adventurism.

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Discussion

Background

8. The six Persian Gulf states (Saudi Arabia, Iran, Kuwait, Iraq, Abu Dhabi, and Qatar) and the two states in North Africa (Libya and Algeria) that belong to the Organization of Petroleum Exporting Countries (OPEC) account for nearly half of Free World oil production and about three-quarters of the oil moving in international trade. They collectively supply 75% to 80% of Western Europe's oil and 90% of Japan's. Moreover, their dominance in the world oil trade seems assured for the foreseeable future since they have about 75% of the Free World's proved oil reserves.

9. The American stake in these eight countries is great. They supply less than 5% of US oil consumption including oil shipped directly to US forces in Vietnam 1/; but, of the \$7 billion that Western oil companies have invested in these countries, \$3 billion is accounted for by US firms. 2/ American companies have invested \$1.3 billion in Libya alone. In the four largest oil producers under review -- Saudi Arabia, Iran, Libya, and Kuwait -- US companies control 95%, 40%, 90%, and 50%, respectively, of the oil production. Repatriation of company earnings yields an annual net capital inflow of \$1.6 billion to the United States from the group of eight countries. A US surplus in commodity trade brings the total annual benefit to the US balance of payments to something in excess of \$2 billion, and this during a period when the United States is running a chronic and serious deficit in its global balance of payments.

10. In the late 1950s, a burgeoning world oil surplus caused a price decline that was not reversed until 1970. When reversal did come, it resulted

1. The United States is the world's leading producer as well as consumer of oil, supplying three-quarters of its own needs. Most of the remainder is supplied by imports from Venezuela and Canada.
2. Investment has been valued at original cost without allowance for depreciation or subsequent increases in replacement cost.

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from shrewd maneuvering by the producing countries that took advantage of a shift of bargaining power. Factors in this shift were continued closure of the Suez Canal; rupture of Tapline (Trans-Arabian Pipeline); a tanker shortage resulting from the longer hauls necessitated by loss of the Canal and Tapline; and rapidly increasing dependence on oil as a source of energy. In recent years, oil consumption has been rising 10% annually in Western Europe and 15%-20% in Japan. By 1970 the oil companies and oil importing states were highly vulnerable to a concerted push by the exporting states for greater financial benefits.

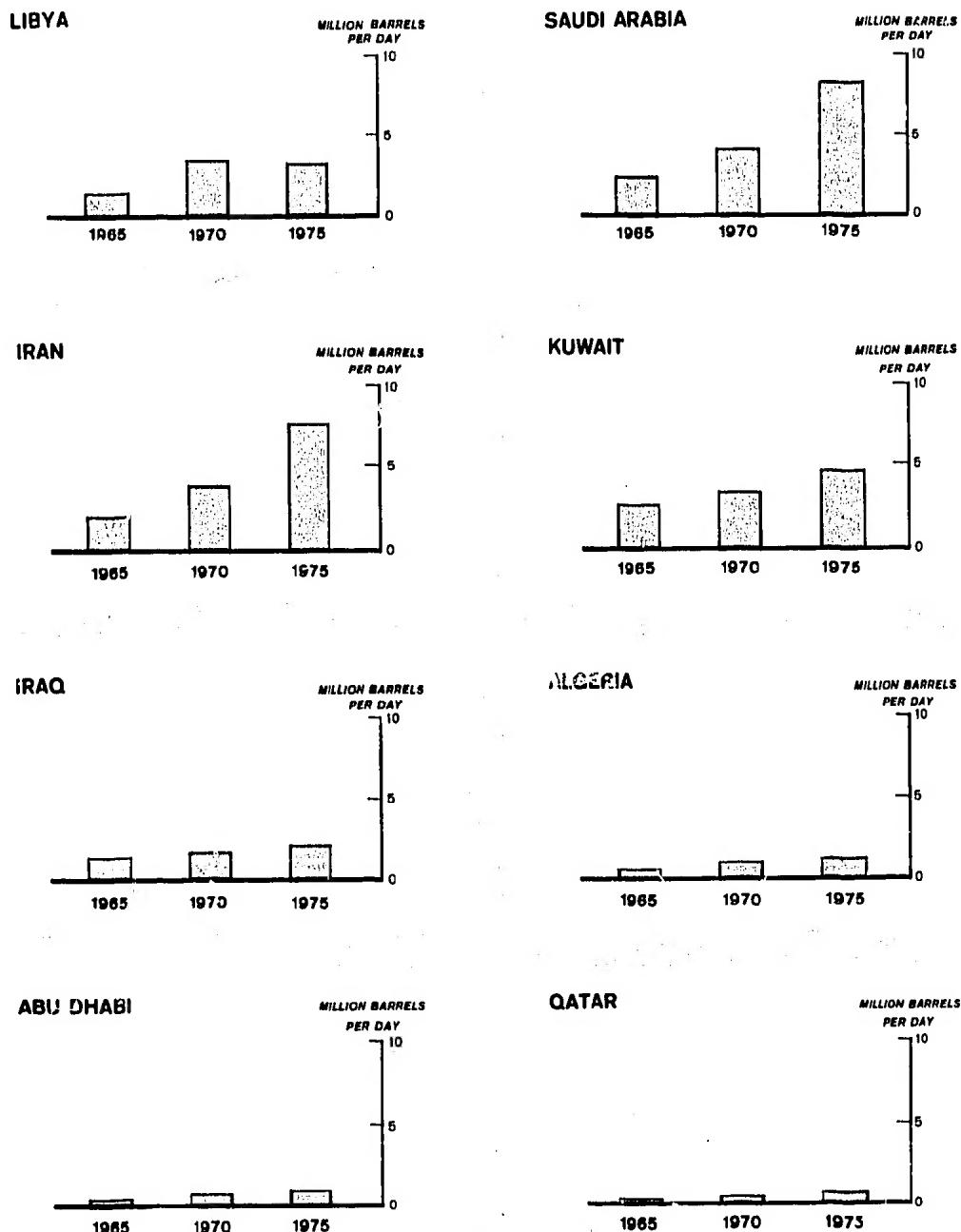
11. In 1970 the OPEC members agreed to force an increase in unit revenues from oil. Libya substantially boosted its tax take in September, and the Persian Gulf producers obtained a small increase before the end of the year. Then, on 14 February 1971, after strenuous negotiations, the Persian Gulf producers bargaining as a unit under the aegis of OPEC concluded an agreement with the companies that provided the following: (a) assurance from the producing countries of security of supply and stability of financial arrangements for five years (1971-75), (b) stabilization of the income tax rate on Gulf crude oil export profits at 55%, (c) uniform increase of 35¢ per barrel in the posted price (that is, the price on which taxes are based) of Gulf crude, (d) an inflation adjustment in the posted price of 2-1/2% effective 1 June 1971 and on the first of each of the years 1973 through 1975, (e) further increases of 5¢ per barrel in the posted price on the same four dates, and (f) elimination of some earlier allowances used by the companies in computing profits.

12. The revenue increases that will result from the Persian Gulf settlement are considerable. Revenues will increase about \$1.3 billion in 1971 alone as a result of the changes in tax terms -- that is, posted prices and tax rates. The increase in per barrel taxes will rise to about 60¢ in 1975 and will push 1975 revenues to three times the 1970 level when coupled with the anticipated increase in production (For charts on revenue and production, see Figures 1 and 2).

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OIL PRODUCTION

Figure 1



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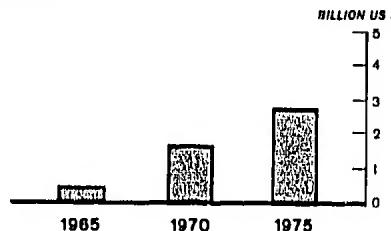
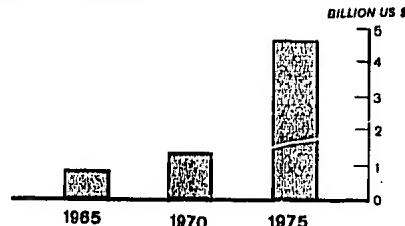
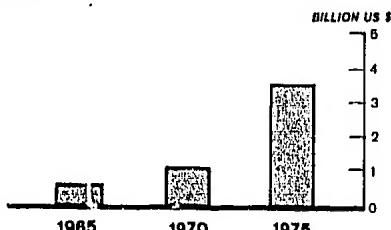
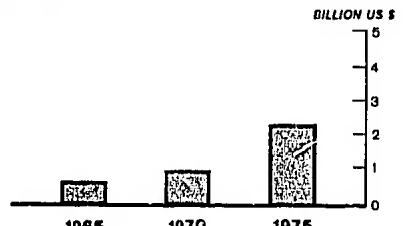
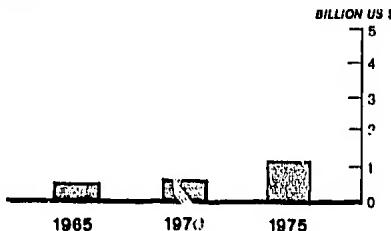
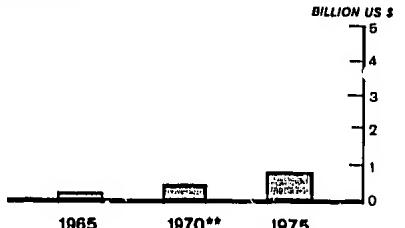
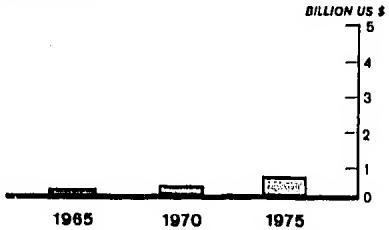
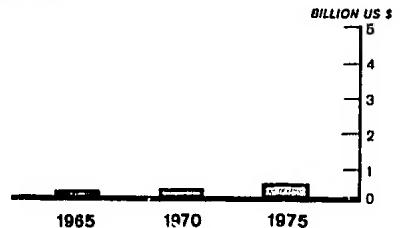
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OIL REVENUE

Figure 2

LIBYA**SAUDI ARABIA****IRAN****KUWAIT****IRAQ****ALGERIA*****ABU DHABI****QATAR**

*Includes the estimated net earnings from oil production of SONATRACH, the State oil company.

**Excludes about \$100 million in retroactive taxes imposed in 1971.

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13. The disparity among the six Persian Gulf countries in both total revenues and revenue increases is considerable and reflects primarily differences in the level and rate of growth of oil output. Because of their pre-eminent output roles, Iran, Saudi Arabia, and Kuwait receive most of the area's total revenue and will receive the biggest increases under the new agreement, roughly six-sevenths of the total. About two-thirds of Iraq's oil and a small portion of Saudi Arabia's is exported via the Mediterranean, however, and revenue terms for this oil were not fixed by the February Persian Gulf agreement. Terms for this Mediterranean oil were not settled until June 1971 and are similar to the terms for Libyan oil.

14. Libya obtained sizable concessions from the oil companies in two series of agreements, the first concluded in September 1970 and the second in April 1971. The latter settlement, like the Persian Gulf pact, is intended to cover a five-year period. The Libyan bargaining position was very strong because, at the peak in May 1970, Western Europe depended on Libya for 30% of its oil. Libya increased the pressure by ordering selective production cutbacks that reduced output 20% and by threatening to shut off production altogether. Moreover, the sharpest cutback was imposed on Occidental Petroleum, an independent US company with virtually all its producing assets in Libya. Occidental acceded to most Libyan demands in September, and the other companies soon followed suit. The Libyan government continued to hold production below the peak level, however, and in January announced further demands that finally resulted in new agreements in April. Together the two rounds of agreements will raise Libyan revenues by 90¢ or more per barrel, over the coming five years, more than two-thirds of this increase stemming from the April settlement. Libya was able to push the tax-paid cost of its crude well above Persian Gulf oil at least temporarily because of the higher gravity and lower sulphur content of Libyan oil and because of the transportation advantage resulting from Libya's proximity to Europe, the continued closure of the Suez Canal, and the relative scarcity of tankers. Opening of the canal and a decline in tanker rates would eliminate 25¢ a barrel in special premiums from the posted price; however, the

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net effect of these developments would be a smaller reduction in the European price of Libyan oil than in that of Persian Gulf oil.

15. If the production ceiling of 3.2 million barrels per day imposed last December is maintained (as it may be to conserve oil reserves), Libyan oil revenues will approximate \$2.6 billion in 1975. This is about 80% above the 1970 level. Production may in fact be cut back somewhat, restraining the growth of revenues.

16. Although the Libyan settlement set the pattern for agreements governing Saudi Arabian and Iraqi oil exports via the Mediterranean, no such agreement was concluded until June. Negotiations were prolonged by Iraq's unsuccessful demand for a premium based on the low paraffin content and high lube yield of its oil. This premium would have paralleled that obtained by Libya for the high gravity and low sulphur content of its oil.

17. The Libyan settlement also will serve as a benchmark for an agreement between Algeria and the French oil companies operating there. The Algerian situation, however, has been greatly complicated by special Franco-Algerian arrangements and problems that are a legacy from colonial times. 3/ Negotiations between Algeria and the French companies have been going on since November 1969, and since late 1970 the situation has amounted to a confrontation. Algeria has greatly escalated its demands, made numerous threats, and taken unilateral action. In February 1971 the nationalized portion of the formerly French-controlled companies was increased to 51%, and oil and natural gas pipelines and natural gas deposits -- almost all of which were at least partly French-owned -- were completely nationalized. Although compensation was offered for nationalized assets, Paris declared it inadequate. In April the tax take from oil produced by the French was boosted from 78¢ per barrel to \$1.83 per barrel. The French government took

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retaliatory steps that effectively terminated preferential economic ties between France and Algeria. All French oil companies stopped transferring 4/ earnings to Algeria for retention there, and most of them stopped paying taxes to Algeria. Algeria responded by demanding that \$2.95 per barrel be paid at Algerian ports when the French companies loaded oil tankers. Unable to realize a profit at that price, French companies stopped loading Algerian crude in April and took measures to prevent or discourage other companies from buying "their" oil. As a result, Algerian oil exports fell initially to 30% of the previous year's rate, but a portion of the decline already has been recouped by SONATRACH (Algeria's state oil company). At the present time the situation remains at an impasse. When an arrangement eventually is worked out, it should provide Algeria with a substantial increase in revenues.

18. Changing market conditions and the push for higher revenues also brought gains to oil exporting countries that are outside the scope of this memorandum. Nigeria received concessions following Libya's gains last September and subsequently has obtained a five-year settlement on terms comparable to those secured by Libya in April. Venezuela and Indonesia did not negotiate with producing companies for more favorable terms but imposed tax increases effective in March and April.

Revenues, Expenditures, and Reserves, by CountryLibya 5/

19. From 1965 through 1968, the last full year of King Idris' regime, Libya's economy grew explosively, almost entirely because of rapidly expanding oil production. Oil production increased an average of 29% annually, enabling gross national product (GNP) to grow 17% annually.

4. The 1965 Oil Accord provides for the retention of 50% of French petroleum companies' gross earnings in Algeria. However, French companies received payment for oil in France, so the money actually had to be transferred to Algeria.

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20. The oil industry still accounts for about 80% of GNP, the remainder consisting mainly of primitive agriculture and service activities. Many Libyans are still nomadic. There is virtually no manufacturing, and about 60% of food and other agricultural materials for the roughly 2 million inhabitants are imported. Imports are equivalent to about 27% of GNP.

21. The Revolutionary Command Council (RCC) government, which seized power in 1969, in marked contrast to the conservative Idris regime, is vigorously trying to achieve vague goals of economic growth and increased political esteem in the Arab world. The RCC, however, has adopted disparate and even contradictory policies. Initially, the new government sharply reduced domestic outlays by curtailing ordinary expenditures and scuttling some development projects. Although government spending was on the rise by mid-1970, it probably remained below the 1968 level. Efforts to eliminate corruption and a careful review of day-to-day spending continue to restrain outlays. Although substantial sums have been nominally allocated to new industrial and agricultural investment, little has actually been spent because almost none of the required planning and other preparatory tasks have been undertaken. There probably has been some small increase in development spending, however, since several old infrastructure projects have been revived. Although still small, government participation in the petroleum industry has increased. Through the Libyan National Oil Company (the fledgling state oil company), the government is at least nominally involved in all aspects of the industry. In contrast to relatively low spending for domestic economic and social purposes, Tripoli has been liberal in spending for the foreign aid and defense programs. Aid to other Arabs more than doubled during the RCC's first year and reached at least \$300 million in the 12 months ending March 1971. Two large contracts, one with the USSR for arms and the other with France for arms and aircraft, have been signed, and additional arms contracts have been sought with other, mainly Western, suppliers.

22. Libya's already big financial reserves are almost certain to increase rapidly. In February 1971 the country's gold and foreign exchange holdings

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were \$1,688 million, enough to finance 30 months' imports at the 1969 level. With oil revenues expected to increase from \$1.5 billion in 1970 to \$2.6 billion in 1975, we believe it quite likely that Libya's reserves of gold and foreign exchange will approximate \$8 billion by the end of 1975 even if oil output does not increase.

23. RCC interest in economic development has been confirmed by a sharp increase in the amount of money budgeted for this objective. Unlike the previous regime, the RCC is budgeting funds to develop agriculture and non-oil industries. Libya's ability to increase investment in the short run, however, is limited. The problem is that the government has not developed a comprehensive plan for economic development, and none seems to be in the offing. Moreover, a dearth of skilled managers and technicians will hamper the implementation of development projects. Many technocrats present under Idris have been purged, and most Westerners have left. Egyptians have entered Libya to replace Westerners, but they are concentrated in the security forces, health services, and education. The RCC has resisted technical assistance from either the West or the East and has shown some reluctance to admit large numbers of other Arabs. Palestinians, in particular, are not welcome in large numbers.

24. Libya's foreign aid spending probably will depend largely on the political leverage such assistance could be expected to yield. Disillusioned with past results, the RCC recently has reduced aid expenditures sharply. Hussein's treatment of the fedayeen prompted the RCC to end aid to Jordan, while Syrian restoration of Tapline is believed to have led to a stoppage of aid to that country. Khartoum payments to Egypt continue, but ad hoc aid to Egypt appears to have ceased since Sadat began peace overtures to Israel.

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[Redacted] Given continuing Arab-Israeli tension but no hostilities, Libya probably will continue Khartoum payments to Egypt and perhaps extend some ad hoc assistance. An all-out war effort against Israel would cause a dramatic rise in Libyan aid, while a negotiated

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peace might cause such assistance to terminate. Recently Libya has given Algeria financial aid in its dispute with France. Significant aid increases might also be associated with Libyan entry into federation with Egypt and Syria. But the amounts Libya would provide would not likely be large in terms of the country's revenues.

25. Unaffected by financial restraints for a number of years, Libyan arms expenditures have been determined by RCC desires. The RCC is currently seeking approximately \$700 million worth of arms. Two contracts totaling \$500 million were signed with France (\$400 million) and the USSR (\$100 million)

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26. Although the Libyan government will have the opportunity to increase development spending in the next few years and its military and foreign aid outlays may remain high, it will be hard put to spend more than half its foreign exchange income. If the RCC manages to organize a development program, it could, in the next few years, overcome shortages of skilled and even slightly skilled labor by hiring foreigners, while at the same time importing the necessary equipment. However, the RCC probably will not carry its pan-Arab sentiments so far as to risk much dilution of Libya's national identity. Until restraints on immigration are eased, labor shortages will severely constrain economic development. Substantial expenditures also could be made on welfare, but the Libyan regime is strongly inclined toward a conservative social policy. In any event, Libya will be unable to increase either welfare or development expenditures greatly in the next two or three years because of the inevitable lags between decision and implementation.

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27. Given these constraints on development and welfare spending, Libya will probably have balance-of-payments surpluses of nearly \$1.5 billion a year in 1972 and 1973. Even rapid increases in civilian imports (50% in three years), combined with payments on the large arms contracts already made or expected and continuation of Khartoum payments, would give this result. A level of per capita imports equal to that of Kuwait -- an extremely unlikely development -- would still leave a surplus of more than \$1.0 billion in 1972. This assumes constant oil production. Under these circumstances, imports for use in the oil industry would be small. If oil production increased, foreign exchange earnings would be further raised, but a small part would be spent on increased imports for the oil industry.

28. The chances are good, therefore, barring large new foreign aid, that, by the end of 1973, Libyan foreign exchange reserves could rise to more than \$6 billion -- equivalent to about 50% of present US reserves. For a regime committed to raising its prestige, especially in the Arab world, and willing to use its economic muscle to gain political advantage, the potential for using this wealth to cause problems for the West is considerable indeed.

Saudi Arabia 6/

29. Prior to the recent oil agreements, Saudi officials were deeply concerned with what they saw as an impending financial crisis. They were alarmed by three consecutive years of small deficits in the government budget -- the first deficits since 1959 -- and, even more, by the associated 16% drop in the country's traditionally large foreign exchange holdings between 1967 and 1969. 7/ End-of-year reserves had fallen from \$944 million to \$785 million because of sharply increased imports for development and defense, expanded payments on

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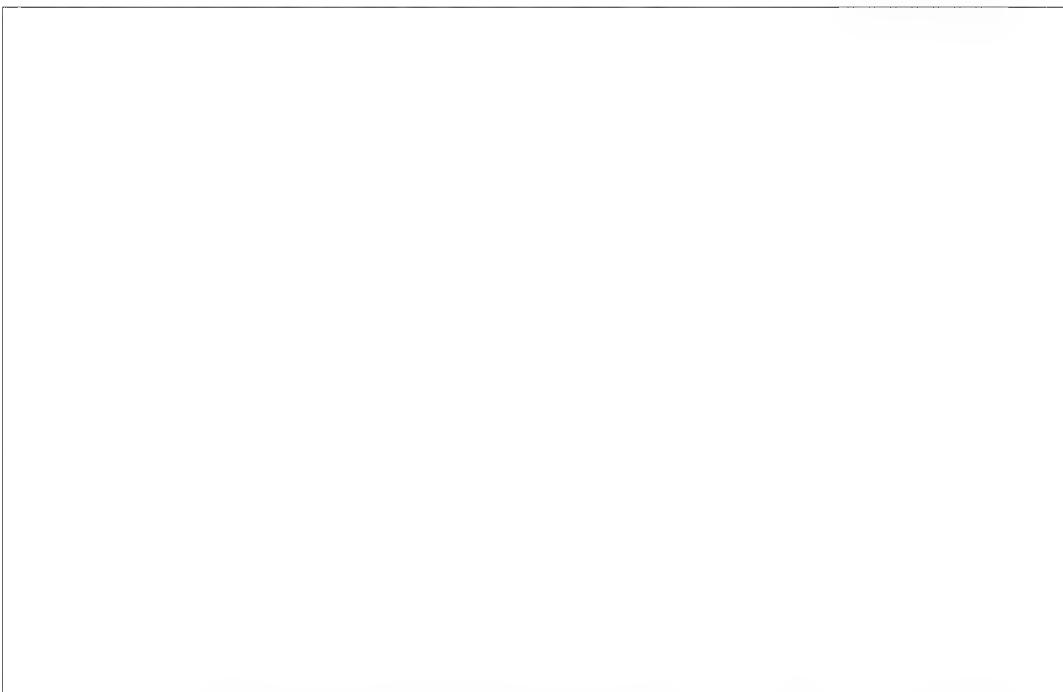
7. Foreign exchange holdings include gold and foreign currency held by the Saudi Arabian Monetary Agency (SAMA) and SAMA investments abroad, which generally are highly liquid.

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military debt, and aid to Egypt and Jordan induced by the 1967 Arab-Israeli War. Outflows for aid and arms alone increased from about \$175 million in 1967 to \$370 million in 1969 [redacted] By early 1970, reserves were substantially below the desired level of 1.5 times annual imports, though still well above the level required by law as currency cover. The financially conservative Saudis became increasingly apprehensive about their reserves and took several steps to reduce outlays.

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30. One important economy measure was a sizable cutback in development expenditures. For fiscal year 1971, 8/ development expenditures were budgeted at \$276 million, some \$78 million less than in FY 1970 and less than half the level of planned defense spending. Only \$22 million was allotted to new development projects compared with an estimated \$100 million the year before. The reduction in development spending caused economic growth to slow in the second half of 1970. The growth of real GNP, which had averaged 8.5% annually for a decade,

8. The Saudi fiscal year runs from 2 September 1970 to 21 August 1971. The Saudi "hijra" fiscal year is shorter than the Gregorian year; hence its Gregorian equivalent changes from year to year.

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slowed to 4.5% in 1970. The slackening economic tempo was reflected in a one-third reduction in import growth and consequent improvement in the balance of payments. Foreign exchange holdings climbed by \$109 million to \$894 million by the end of 1970.

31. In late December 1970 Saudi Arabia secured an agreement, retroactive to 14 November, that raised its oil revenues by about 8%. This agreement raised posted prices 9¢ a barrel on medium and heavy crudes and raised the tax rate on company profits from 50% to 55%. It alone was sufficient to raise government revenue \$145 million in 1971 (including \$15 million in retroactive payments for 1970) and about \$250 million annually by 1975 (see Table 2).

32. Further revenue increases occurred in late 1970 and early 1971, when the posted price of Mediterranean oil was increased at Libya's instigation and transit fees were raised on oil passing through the 540-mile Saudi portion of Tapline to the Mediterranean. The increase in posted price will bring Saudi Arabia an extra \$18 million to \$21 million annually from exports via Tapline, and the boost in transit fees will provide another \$12 million to \$13 million annually. Saudi Arabia also will receive a payment of \$9 million to cover retroactive Tapline claims, two-thirds of which will be paid in 1971 and the remainder in small installments through 1973. In addition, Saudi Arabia should receive annual gains rising from \$60 million to \$112 million during 1971-75 from the settlement on Mediterranean exports.

33. By far the largest revenue increase for Saudi Arabia will come from the 14 February OPEC agreement covering oil exported via the Persian Gulf. Under this settlement, Saudi Arabia will receive about \$400 million in additional oil revenues in 1971 alone. The 14 February agreement calls for escalation of unit revenues each year through 1975, when the Saudi increment will reach \$1.4 billion.

34. Not only will Saudi Arabia gain major revenue increases from each barrel of oil exported under the new agreements, but also total revenues

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Table 2
Saudi Arabia: Oil Revenues

	Million US \$					
	1970	1971	1972	1973	1974	1975
Oil revenues anticipated under pre-September 1970 agreements	1,223	1,456	1,844	2,242	2,484	2,737
Additions from new agreements						
30 Dec 1970 (retroactive to 14 Nov 1970)	15 a/	130	167	205	228	252
Late 1970 (Libyan settlement applied to Saudi Tapline shipments b/)	c/	18	20	20	21	21
1 Feb 1971 (increased Tapline transit fees instigated by Syria)	c/	12	12	13	13	13
Retroactive payments		6	2	1	0	0
14 Feb 1971 (agreement on Persian Gulf oil)	c/	362	560	812	1,033	1,305
Saudi share of increased revenue for neutral zone (assuming equal treatment)		34	51	62	75	87
Mediterranean agreement (estimated minimum terms)	c/	60	64	78	94	112
Total additions		<u>622</u>	<u>876</u>	<u>1,191</u>	<u>1,464</u>	<u>1,790</u>
Estimated new oil revenue schedule	1,223	2,078 +15 a/ 2,093	2,720	3,433	3,948	4,527

- a. To be paid in 1971.
- b. Tapline was closed from 4 May 1970 until 1 February 1971.
- c. Not applicable.

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will be enhanced by rising output. Oil production during 1971-75 may grow more than 15% a year.

35. Given anticipated production levels, the new agreements will boost revenues by about \$640 million, or 44%, in 1971 alone. By 1975, oil revenues will be nearly two-thirds larger than they would have been under the old agreements and 3.7 times as great as in 1970. So far, the government seems to have proceeded cautiously with its spending, letting reserves accumulate. However, the extraordinary rise in oil revenues will enable the government to carry out fully all existing development and defense programs, initiate new ones, and continue or even expand foreign aid programs.

36. Although Saudi Arabia's population is only perhaps 4 million, the non-oil sectors of the economy are so backward that the scope for economic development is considerable. Development expenditures probably will be raised at least \$900 million above the \$2.5 billion originally earmarked for 1971-75 to the level initially regarded as optimum by Saudi planners. Planning delays and other administrative problems may hold back spending for a year or two, but a significant part of the revenue increase could be flowing into development by the mid-1970s. Saudi Arabia apparently is willing to import the skilled labor (its principal resource constraint) needed for accelerated development.

37. Increases in defense spending beyond the \$3.1 billion previously proposed for 1971-75 are nearly inevitable under strong pressure from special interest groups within and outside the government. The \$3.1 billion program was conceived during a time of financial difficulties and was designed to meet only so-called "basic military needs." Saudi officials, however, have expressed keen interest in a considerably expanded military development program that would include more naval vessels, more aircraft, additional tanks and miscellaneous vehicles, and substantial investment in facilities. Should they opt for the total package, an additional \$100 million or so might be spent on the air force and \$500 million on the other services. The Saudis do not have the technical capacity to maintain and operate so much new equipment, but they may well buy it anyway.

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38. Saudi Arabia is likely to be pressed for increased foreign aid because of its strong foreign exchange position. Riyadh already has yielded to repeated Jordanian and Egyptian pleas for payment of all Khartoum aid in hard currency rather than part payment in crude oil as earlier proposed by the Saudis. In addition to giving Jordan and Egypt more financial support, Saudi Arabia could well increase aid to Yemen in its campaign against their mutual antagonist, Southern Yemen. Neighboring Persian Gulf states also might receive more assistance as the Saudis compete with Iran for influence in this area following British withdrawal. In all, some \$200 million in additional aid might be disbursed during 1971-75.

39. Even if Saudi Arabia makes all the additional expenditures outlined above for economic development, defense, and foreign aid in 1971-75, it still will have several billion dollars in oil revenues to spend for new programs or add to reserves. Saudi Arabia is in a good position to raise foreign exchange reserves from \$894 million at the end of 1970 to the neighborhood of \$8 billion by the end of 1975.

Iran

40. Prior to the recent boost in oil revenues, Iran was walking a financial tightrope. An economically awakening country of some 30 million people, Iran had great need for economic development. The Shah's government was responding vigorously to that need with costly programs, and considerable progress was being achieved. Nevertheless, per capita GNP still was only \$320 a year as the decade of the 1960s drew to a close. Besides spending freely on economic development, Iran was laying out large sums to buy military equipment and otherwise strengthen its armed forces. Defense expenditures rose to about 9% of GNP. Determined that Iran become the dominant power in the Persian Gulf following British withdrawal, the Shah sought to provide his forces with "all the means short of nuclear weapons required to protect Iran in any eventuality in the region." Oil production and revenues doubled between 1965 and 1970, but the development and military programs caused such an outflow of foreign exchange that the balance of

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payments was chronically under pressure. Large sums were borrowed to finance development and military imports, and, despite the concessionary nature of much of the borrowing, outlays for debt servicing became sizable. Perhaps \$300 million went for debt service in 1970 alone. By the end of 1970, Iran's holdings of gold and foreign exchange had fallen to a six-year low of \$209 million, equivalent to less than two months' imports.

41. Iran gained some respite from financial pressure in late 1970 from posted price and tax rate increases parallel to those secured at the time by Saudi Arabia. Like its neighbors, however, Iran is reaping its big gains from the 14 February agreement. 9/ Iran's oil revenues are expected to more than triple between 1970 and 1975 under the combined impact of the new agreements and an upsurge in oil production (see Table 3).

Table 3
Iran: Oil Production and Revenues

<u>Year</u>	<u>Production (Thousand Barrels per Day)</u>	<u>Revenues (Million US \$)</u>
1965	1,887	522.4
1966	2,113	593.4
1967	2,597	736.7
1968	2,841	817.1
1969	3,375	937.8
1970	3,829	1,050
1971	4,400	1,700
1972	5,000	2,000
1973	5,700	2,400
1974	6,500	2,900
1975	7,400	3,400

9. The Shah served as principal spokesman for the OPEC states during negotiation of the 14 February agreement.

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42. The increase in anticipated revenues afforded Tehran an opportunity either to push expensive programs further or to pay off burdensome short- and long-term debts. However, the Shah revealed his commitment to the former course just 10 days after the conclusion of the February agreement. At that time he proposed a budget for fiscal year 1971/72 (21 March 1971 to 20 March 1972) that not only will consume the increase in oil revenues but also will require further substantial deficit financing. Both development and military spending are to be increased. The budgeted deficit is \$1.4 billion, or about one-fifth of expenditures, and is to be covered by a combination of foreign and domestic borrowing. The heavy recourse to foreign borrowing will increase debt service costs, which now consume 15% to 20% of foreign exchange earnings.

43. It is unlikely that the Shah will swerve from his twin objectives of economic expansion and enhanced military strength during the first half of the 1970s. As a consequence, Iran will continue to walk a financial tightrope despite the huge increase in its oil revenues. Reserves of gold and foreign exchange probably will be held in the relatively low range of \$200 million to \$400 million.

Kuwait

44. Kuwait, with big oil revenues and a population of only 800,000, long has been one of the most prosperous countries in the Middle East. The government has spent lavishly to enhance the welfare of the country's people and has extended significant amounts of aid to other Arab countries. Foreign aid has been extended both through the Kuwait Fund for Arab Economic Development and directly to foreign governments in the form of grants and concessionary loans. Kuwait committed itself in the 1967 Khartoum Agreement to give Egypt \$91 million and Jordan \$41 million annually to offset these countries' losses from their conflict with Israel. Payments to Jordan, however, currently are suspended because of disapproval of Hussein's policy toward the fedayeen.

45. The growth of economic output in Kuwait has slowed in the past five years, largely because the growth of oil production slowed to less than 6% a

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year. The outflow of capital in the form of Khartoum aid was another negative factor. In addition, other funds left Kuwait in search of higher interest rates as the government maintained an interest ceiling of 7% despite the attraction of higher rates in other countries. In an attempt to compensate for the capital outflows, the government canceled or postponed development expenditures, further dampening economic activity.

46. Military expenditures doubled between fiscal years 1965 and 1970 but still were small in absolute amount. ^{10/} Including expenditures on the constabulary and the national guard, military spending came to \$130 million in fiscal year 1970. Kuwait has bought only small amounts of military equipment abroad, most of it from Great Britain. The purchase of a mere \$24 million worth of British military goods in 1969 ranks as an exceptionally large buy for Kuwait.

47. Although Kuwaiti economic progress slowed in the later 1960s, some advancement was achieved. Oil production and government revenues from oil -- of overwhelming importance to Kuwait -- continued to rise from year to year. Moreover, foreign exchange reserves remained relatively stable at a high level. At the end of 1970, Kuwait's reserves of gold, foreign exchange, and other foreign assets probably amounted to at least \$1.3 billion. This accounting, like that given for Saudi Arabia, includes not only the reserve holdings of the central bank but also other foreign assets of the government. Many of the assets are held by commercial banks acting as financial intermediaries for the government.

48. Like the other countries in the area, Kuwait achieved some gains in late 1970 through increases in posted prices and the tax rate on profits, but the big gains came with the 14 February settlement. The combined effect of rising production and increased unit revenues will boost the Kuwaiti government's revenues from oil by about

10. The Kuwaiti fiscal year runs from 1 April through 31 March and is designated by the calendar year in which it ends.

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\$500 million, or 50%, in 1971 alone. By 1975 oil revenues will be 2.4 times as great as in 1970 (see Table 4).

Table 4
Kuwait: Oil Production and Revenues

<u>Year</u>	<u>Production (Thousand Barrels per Day)</u>	<u>Revenues (Million US \$)</u>
1965	2,330	671.1
1966	2,473	707.2
1967	2,481	717.6
1968	2,607	765.6
1969	2,781	817.0
1970	3,059	960.2
1971	3,300	1,500
1972	3,600	1,600
1973	3,900	1,800
1974	4,200	2,100
1975	4,500	2,300

49. Part of the upsurge in oil revenue will go into welfare and development programs. Development projects that had been held back will be reinstated, and new projects will be launched. However, this small country's ability to absorb developmental investment is limited. Another portion of the revenue may be used to expand military procurement, but Kuwait will not become a major buyer of arms. Aid to other countries, including contributions to the Kuwait Fund for Arab Economic Development, probably will be increased but not beyond the neighborhood of \$225 million a year. Despite the increased outlays, Kuwait will accumulate sizable amounts of foreign exchange, most of which probably will be invested abroad in short- or medium-term assets by the government acting either directly or through commercial banks. By the end of 1975, Kuwait's reserves should be in the range of \$7 billion to \$8.5 billion.

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The Lesser Producers: Iraq, Algeria,
Abu Dhabi, and Qatar

50. Iraq and Algeria have found their revenues from oil to be small in relation to their economic needs. With sizable populations (Iraq nearly 10 million and Algeria about 14 million) and low per capita income (under \$300 a year) the two countries have been struggling with substantial tasks of economic development. Iraq's resources have been strained further by rising defense expenditures and purchases of military equipment from Communist countries. Neither country is a significant aid donor. In 1970, Iraq's oil revenues came to \$540 million and Algeria's \$350 million -- that is, considerably less than the receipts of the larger oil exporters. Algeria's revenues include the earnings of SONATRACH, which is the only state oil company of substantial importance in any of the countries reviewed in this memorandum.

51. Prospective oil revenues in Iraq and Algeria were more or less determined by the Persian Gulf and Libyan settlements. Iraqi oil exported via the Gulf is in fact covered by the Persian Gulf agreement. The two-thirds of Iraqi production that is exported via the Mediterranean Sea is covered by terms similar to those won by Libya in April. The Libyan settlement has determined the approximate price that Algerian oil can be expected to bring through 1975. As noted earlier, however, the Algerian situation has been complicated by nationalization of over half the industry, by the possibility that the remainder may be nationalized as well, and in general by the ongoing dispute between Algeria and the French companies. Total oil revenues should more than double between 1970 and 1975 in both Iraq and Algeria. All of Algeria's oil will benefit from the greater improvement in terms for Mediterranean than for Persian Gulf exports, and Algeria will profit from nationalization of foreign oil assets -- a process that may be carried further.

52. Neither Iraq nor Algeria is expected to accrue large foreign exchange reserves over the coming five years. Iraq probably will take advantage of its increased revenues to relax foreign exchange controls while continuing expenditures on economic development and the strengthening of its

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military establishment. By the end of 1975 Iraq's reserves of gold and foreign exchange probably will have increased moderately to about \$600 million. Having smaller oil revenues and a bigger population, Algeria is expected to push economic development so vigorously that its reserves will not exceed their end-of-1970 level at the close of 1975.

53. Although Abu Dhabi and Qatar are not among the biggest oil exporters, their revenues from oil are large relative to their respective populations of roughly 50,000 and 100,000. Neither state has spent heavily for military purposes, but both have given modest amounts of aid to nearby Persian Gulf states and both have spent significant sums on economic development. In 1969, half of the Abu Dhabi government's expenditures went for development. Such expenditures have not been sufficient to prevent either Abu Dhabi or Qatar from accumulating substantial holdings denominated in foreign currencies, although Abu Dhabi did encounter financial problems that led to a sharp curtailment of imports in 1970. Official reserve figures greatly understate these countries' reserve positions because they exclude foreign assets held by the ruling families and perhaps other assets as well. Such holdings include sizable investments in other countries that are readily marketable. The total foreign assets of Abu Dhabi and Qatar can only be estimated roughly, but they have been put at \$500 million and \$300 million, respectively, at the end of 1970.

54. Oil revenues are expected to double in Qatar and triple in Abu Dhabi between 1970 and 1975 (see Table 5). These states' exports benefit from the gains secured by the 14 February Persian Gulf agreement, and production is increasing in both countries, particularly in Abu Dhabi. Given the modesty of their inclinations toward military spending and foreign aid and the limits on their capacity to absorb development spending, both Abu Dhabi and Qatar seem destined to add greatly to their foreign holdings in the coming years. By the end of 1975 these two tiny states may hold foreign assets approximating \$2.5 billion and \$1 billion, respectively.

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SECRET**Table 5****Abu Dhabi and Qatar: Oil Revenues**

<u>Year</u>	<u>Abu Dhabi</u>	<u>Qatar</u>	<u>Million US \$</u>
1965	34	74	
1966	100	91	
1967	106	102	
1968	153	112	
1969	187	118	
1970	261	136	
1971	390	200	
1972	480	220	
1973	560	240	
1974	660	270	
1975	780	290	

Implications for the United States**General**

55. Increases in Middle Eastern and North African oil levies will affect the United States through their impact on the oil exporting countries' foreign exchange receipts. The increased receipts can be used by the Middle Eastern regimes to finance increases in imports or foreign aid or be allowed to accumulate as foreign exchange reserves. They may be channeled into economic or military programs, investment abroad, or various mischief-making activities. However, expenditures are likely to fall far short of revenues. The huge size of the hard currency reserves that seem almost certain to be piled up represents a major challenge to US political and commercial policy planning.

56. The effect of the new levies on oil prices in the United States and on the earnings of US oil companies that operate in the Middle East and North Africa should be slight. Producing companies are passing the tax increases along to consumers via higher prices, and demand seems to be sufficiently inelastic to make the price hikes stick. Little of

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this oil, however, is marketed in the United States, and US oil prices are above the world level and insulated from external conditions by a system of import quotas. Moreover, the passing along of higher tax-paid costs means that company profits will not be reduced. Repatriation of profits to the United States could of course be restricted, and this already has been threatened -- notably by Libya -- but that is another matter.

US Exports

57. The enhanced prosperity of the Middle Eastern and North African oil exporting countries brightens the prospects for US exports to them. At present, however, commodity trade between the United States and the countries under review is relatively limited. Even though the balance of this trade is heavily in favor of the United States, sales to these countries now constitute only 2% of all US exports. In 1969, US sales to these countries were valued at \$830 million, while imports from them amounted to less than \$310 million. Iran received over 40% of the US exports to the area. (For a chart on Middle Eastern imports, see Figure 3.) US exports to this group of countries declined 8% in 1970, led by drops in sales to Libya and Kuwait. Corresponding US imports fell even more rapidly, by 27%. Some of the oil exporting countries are seeking sophisticated military hardware. For example, Libya has ordered 110 Mirage aircraft from France, and Iran has ordered 330 Chieftain tanks from Great Britain (see the photographs), delivery of these items to be spread over several years. The potential for military sales in the area by the United States may be considerable.

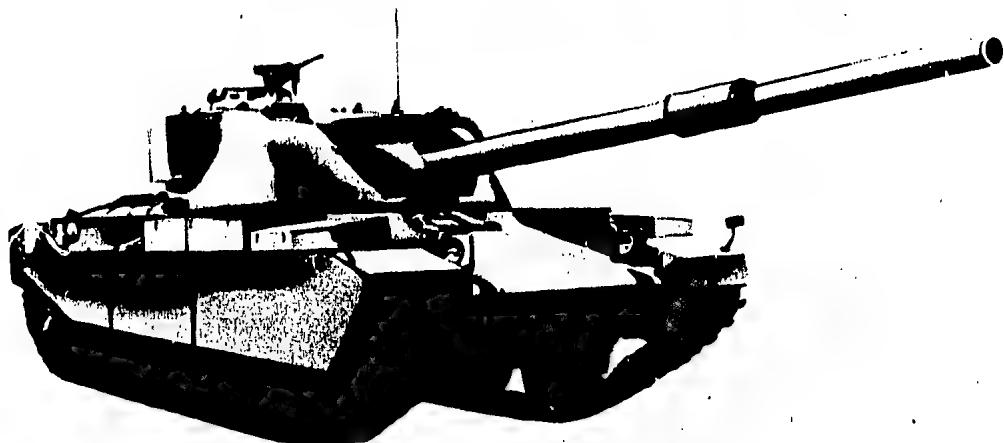
58. Prospects for greatly increased US exports to Libya, however, are not favorable, at least in the short term, largely because US-Libyan political relations are cool. The US-owned oil industry buys most of its equipment in the United States and is expected to continue this practice, but the Libyan oil industry apparently will not expand further, at least for some time. The regime probably will prevent any significant increase in imports of consumer goods from any source, and will buy its arms from West European and Communist suppliers. Major increases in Libyan imports of capital goods

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MIRAGE III E AIRCRAFT



CHIEFTAIN MAIN BATTLE TANK

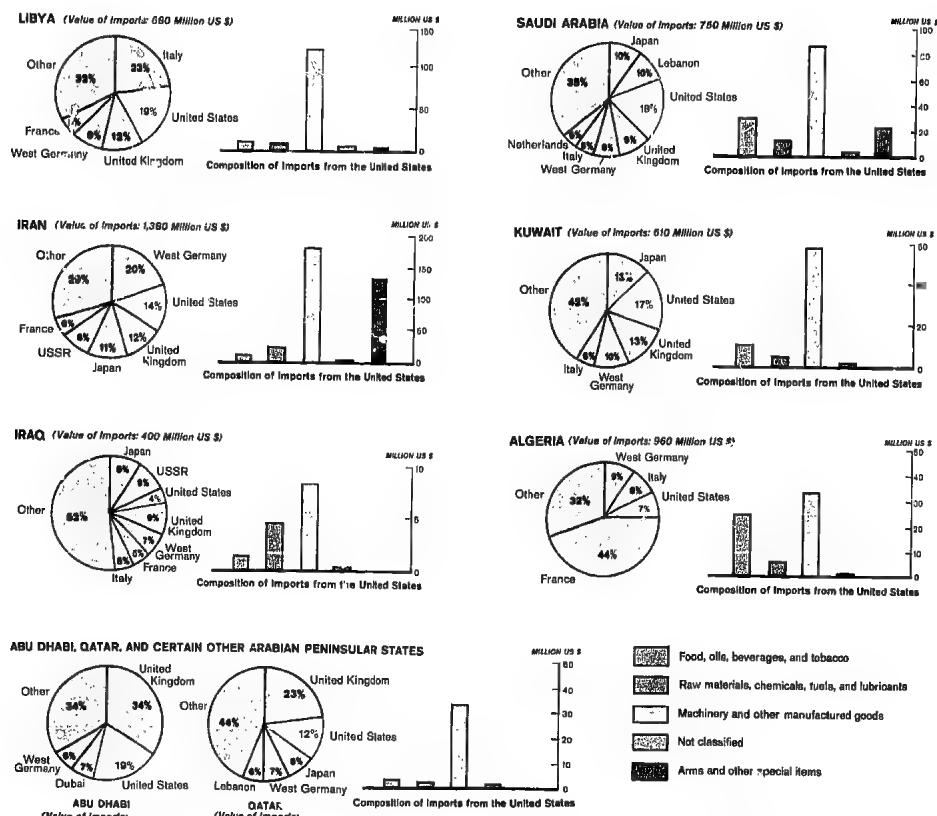
from any source are not expected for several years because at this time Libya has not laid the necessary groundwork for economic development.

59. With its oil revenues growing faster than those of any other country in the group under review, Saudi Arabia should at least retain its position as the United States' second best customer in the group. In 1969, Saudi Arabia imported over \$150 million worth of commodities from the United States, including almost \$25 million in arms and almost \$90 million in machinery and other manufactured goods. Saudi arms purchases, all of which

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SOURCES OF IMPORTS, 1969*

Figure 3



*Pie charts and total import figures exclude arms purchases. Pie chart and total import figures for Iraq and Kuwait are for 1968.

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are made in the West, may more than double between 1970 and 1975. While the United States has been a major supplier in the past, the Saudis' arsenal of modern arms now consists primarily of British equipment with some items of French manufacture. Other imports, including consumer goods and capital goods for development projects and for the oil industry, also will rise, though not as rapidly. Ample foreign exchange will be available, but the Saudis traditionally follow a cautious spending policy.

60. Iran, with oil revenues increasing at the second fastest rate in the group of countries under review, is likely to expand its purchases from the United States considerably and may remain America's best customer. In the past, Iran has spent foreign exchange as fast as it came in on development projects and armaments, and it has borrowed extensively. The Shah is expected to continue to press economic development efforts as well as his program to replace Britain as the dominant political and military power in the Persian Gulf. Foreign suppliers of both capital goods and military equipment will find an expanding market in Iran. In 1969, Iran bought over \$130 million worth of arms and over \$180 million worth of machinery and other manufactured goods from the United States alone. The United States, however, faces considerable competition in the Iranian market. Iran has demonstrated a pragmatic inclination to buy where the terms are most favorable, whether East or West. Recent purchases of British Rapier missiles and Chieftain tanks may have been diverted from the United States by an offer of better credit terms and a more forthcoming attitude on the part of the British. Iran's choice of arms suppliers will continue to depend heavily upon prices and credit terms, as well as the availability and effectiveness of weapons.

61. American exports to Kuwait probably can be expanded considerably in the 1970s. Kuwait has abundant foreign exchange reserves; in 1969 \$75 million worth of its imports came from the United States. With oil revenues rising rapidly, Kuwait can be expected to increase its purchases of both consumer goods and investment goods. Kuwait has made most of its modest arms purchases in Britain -- because of traditional ties -- and this may well be the pattern in the future.

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62. The potential for US exports to Iraq has been limited by the state of Iraqi-US political relations. In 1969, US exports to Iraq amounted to only \$15 million, of which the greater part consisted of machinery and other manufactured goods. In 1970, US exports to Iraq increased but remained below \$25 million. Given US suppliers' present small share in the Iraqi market and the prospective increase in Iraq's foreign exchange earnings, there is room for a considerable increase in US exports to this country. Iraq has demonstrated some interest in US military hardware, even though it has purchased most of its equipment from the Soviet Union and other Communist countries. If political realities permit and favorable terms are offered, Iraq might increase its purchases of capital goods and buy some arms from the United States.

63. The outlook for US exports to Algeria is unexciting. Algerian purchases from the United States are running between \$60 million and \$65 million annually. Future purchases will be a function of financial resources and the state development plan. Financial inflows were cut recently when the French quit importing oil because of the ongoing dispute over taxes, prices, and ownership. Even if oil exports recover their previous trend, as we expect they will, Algerian imports are expected to grow only about 7-1/2% annually. US suppliers of capital goods may benefit somewhat from the recent deterioration in Algeria's relations with France, coupled with Algerian preference for Western equipment and determination to push ahead with economic development. Algeria's relations with the United States have shown considerable improvement over the past year. Growing commercial ties are centered on plans to build liquefaction facilities and export large amounts of liquefied natural gas to the United States.

64. In both Abu Dhabi and Qatar the United States is second only to Great Britain as a source of imports, but these states are so small that they cannot be expected to become important customers for US goods. In 1969, Abu Dhabi, Qatar, and various lesser Arabian peninsular states together bought less than \$40 million worth of US commodities. In 1970, they again bought less than \$50 million worth. With British influence in the Persian

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Gulf waning, Abu Dhabi and Qatar may divert some purchases from Britain to the United States. The market for capital goods should be of primary interest to foreign suppliers. The market for oil equipment is considerable, but this is a function of oil company spending rather than government policy. Any arms purchases will be small.

Some Options for Using Foreign Exchange Reserves

65. The foreign exchange revenues of the oil exporting countries are increasing much faster than their outlays. As a result, the foreign exchange reserves of these countries, which totaled \$5.6 billion at the end of 1970, will rise rapidly and easily should exceed \$25 billion by the end of 1975. The level of reserves is likely to approach \$8 billion in each of three countries -- Libya, Saudi Arabia, and Kuwait. Reserves also will be very large relative to population in the tiny states of Abu Dhabi and Qatar, where respective accumulations of \$2.5 billion and \$1 billion are expected. (For reserves of gold and foreign exchange, see Figure 4.)

66. Some foreign exchange holdings may be converted to gold, invested in the United States and elsewhere, or employed in a variety of international maneuvers. Just how they will be used is a matter of conjecture. Of the states expected to accumulate large reserves, only Libya presently is ruled by a radical regime that might have an inclination toward politically oriented financial maneuvers. However, radical movements or factions may gain power in other countries in the future, and countries ruled by radicals may subjugate some of the wealthy but less powerful oil states.

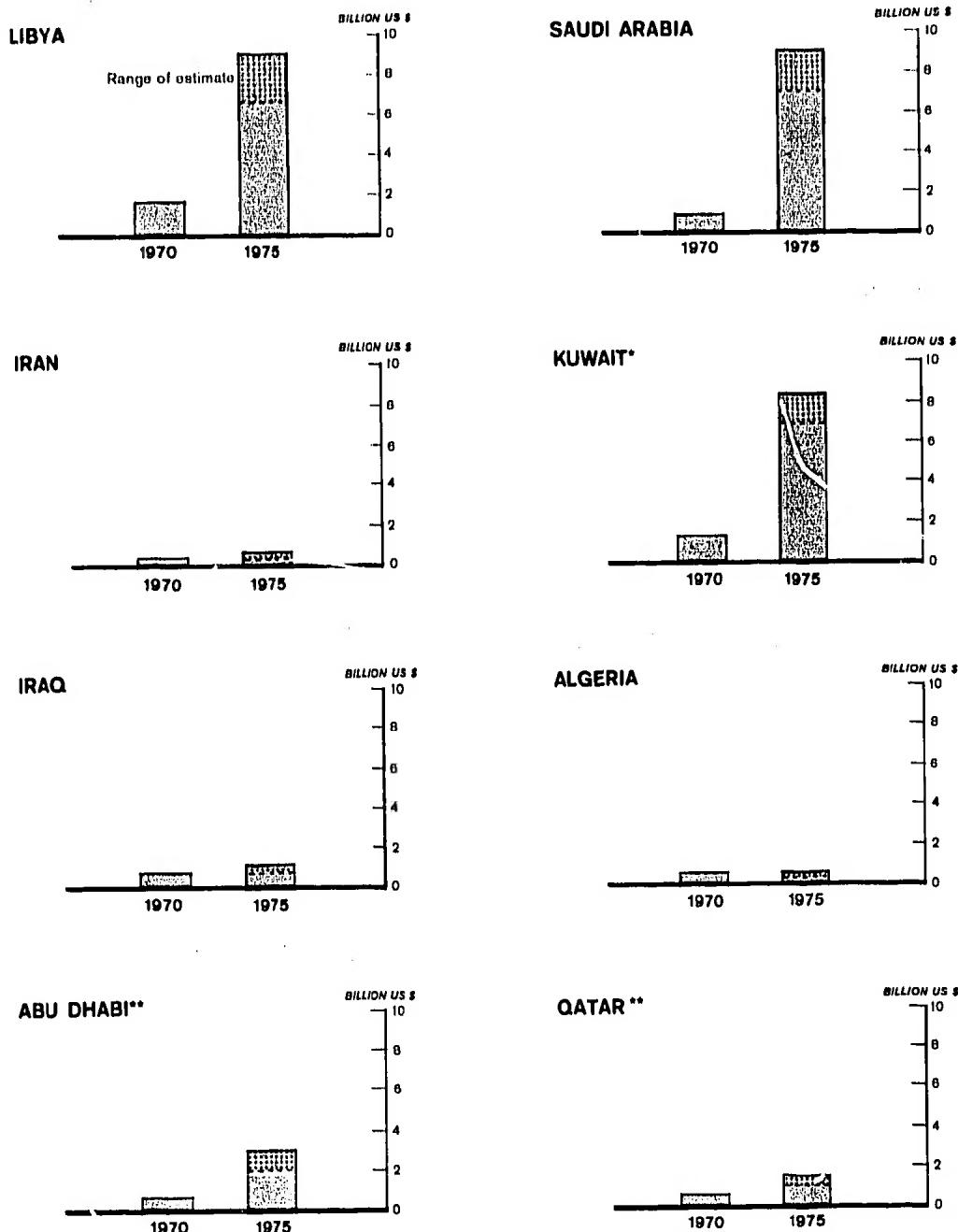
67. Abundant foreign exchange might be used in part to fund a sharp increase in foreign aid. To date, however, the wealthy oil exporting nations have extended assistance in relatively modest amounts, and such aid has been dependent on the policies of recipients. For example, Libya and Kuwait already have suspended Khartoum-agreed payments to Jordan because of disapproval of King Hussein's policies toward the fedayeen. Not only governments but also the fedayeen (depending upon

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Figure 4

RESERVES OF GOLD AND FOREIGN EXCHANGE (End of Year)



*Includes short-and medium-term foreign assets held by the government and by commercial banks.

**Includes foreign assets, in large measure those of the ruling family, that are not officially labeled foreign exchange reserves.

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their viability) and other non-governmental radical political movements are potential recipients of increased aid. Help to foreign political movements might secure the installation of sympathetic regimes in certain countries and could encourage the harassment of unfriendly governments by dissident groups.

68. The wealthy Arab regimes conceivably could disrupt the present system of international payments by accumulating dollar assets and turning them in to the United States Treasury for gold, but most such moves would be likely to involve substantial financial losses by the manipulators. Arab governments, including the present radical regime in Libya, generally have been careful to conserve their assets.

69. Foreign exchange reserves could be used to buy up Western oil interests operating in the Middle East. Partial nationalization already has taken place in Algeria, and a takeover has been threatened in Libya.

70. Large foreign exchange reserves at a minimum will enhance the bargaining power of oil producing countries vis-a-vis the oil companies and consuming countries. A few large producing countries holding ample reserves will be in a powerful position if they cooperate to embargo oil exports in order to enforce demands for higher revenues. In fact, Saudi Arabia, Kuwait, and Libya each will have sufficient wealth and a large enough share in the world oil trade to engage in such maneuvers individually.

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